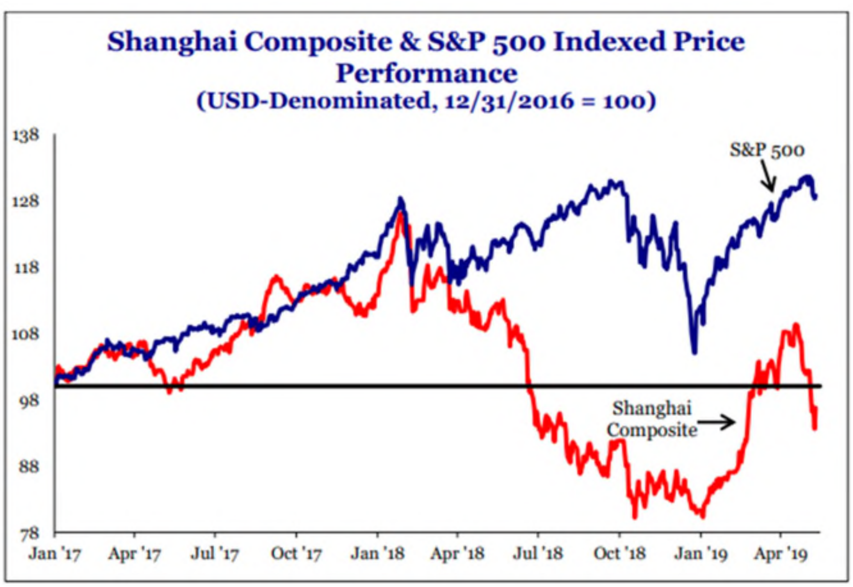
DCM Weighs in on US-China Trade Talks
5-17-19

Last week, the United States trade talks with China came to an impasse. While the negotiations haven't collapsed altogether, the US is accusing the Chinese of trying to renegotiate previously agreed upon structural reforms. As such, President Trump announced that existing tariffs on $200 billion worth of Chinese goods would be increased from 10% to 25%. President Trump also threatened to levy tariffs on an additional $300 billion of Chinese goods should they continue to hold out. In response, the Chinese announced plans to impose tariffs on $60 billion of US goods. Volatility has picked up in light of this recent turn and the S&P 500 now sits roughly 3% below its most recent high.

Despite consolidation over the last two weeks, the S&P 500 is still up around 14% on the year and has made a series of new all-time highs along the way. This recent consolidation is normal and healthy. It has given traders and market speculators an opportunity to take profits after the strong rebound to start the year.

The strength in the early part of 2019 is largely a reflection of the weakness in the closing months of 2018. At the end of last year, markets were washed out by a potent combination of an overly aggressive Fed, trade concerns and the government shutdown. Since then, the Fed has clearly signaled rate hikes are on hold, the government has reopened, and a dash of fiscal stimulus has marginally improved the growth outlook. With this backdrop, economic data and corporate earnings have generally been coming in above expectations. The market has responded accordingly.



Source: Strategas Research Partners - May 2019

While trade is a risk, we have several reasons to be optimistic about the state of the market.

A Supportive Fed

The impact of the trade dispute is particularly manageable with a Federal Reserve that is no longer raising interest rates. Inflation has been decelerating in recent months and currently sits well below the Fed's target levels. The likelihood of the Fed increasing interest rates further has significantly diminished. The market is now anticipating the Fed's next move could be a rate cut. Easier financial conditions should lend support to stock prices.

A Healthy Consumer

The US consumer is in good shape. The US unemployment rate continues to sit near historic lows and wage growth is outpacing the rate of inflation. Being that domestic consumers comprise roughly 70% of the US economy, our economy has a strong foundation. Consumers are still spending at a strong clip, which is good news for corporate profits. We've begun to see evidence that labor productivity is increasing after years of investment in process automation. This means that wages can rise without eating into profit margins, a plus for stock prices.

A Historical Precedent

Strength often begets strength in the market. The S&P 500 made a new all-time high for the first time in six months on April 23rd. Since 1950, the S&P has been up by an average of 13.1% in the 12 months following a new all-time high. Additionally, 24 of 25 observations over that same period have shown positive returns. Evidence also suggests that a positive January, February, March, and April has been bullish for stock prices for the balance of the year. Returns from May to the end of the year in such cases averaged 10% with 14 of 15 observations showing positive returns. History doesn't always repeat, but it is on our side.

This is not to say there may not be bumps along the way. In instances where the first four months of the year were positive, there was an average intra-year decline of 8% for the market. Such moves are often caused by the normal ebb and flow of the news cycle. In time, markets press forward as headlines fade, and the focus shifts back to underlying fundamentals. The recent trade news is likely one of those hiccups.

While our base case is optimistic, there are some headline risks present.

Risks to our Outlook

Trade is manageable with a supportive Fed and a strong fundamental and technical base. However, a prolonged trade war would be a negative for the economy. We expect that recent developments are negotiating tactics that will ultimately bring a resolution sooner rather than later. In the meantime, however, we are closely watching business and consumer confidence for signs that the trade war is under control. Meaningful deterioration in either business or consumer sentiment would lead us to reevaluate our outlook for economic growth.

We are also keeping an eye on rising geopolitical tension. US and Iranian relations have soured in recent weeks and military assets are mobilizing on both sides. While the response in the oil market has been minimal, this conflict has the potential to disrupt the energy space. We are watching closely for changes.
Politics are also coming back into play as we move closer to the 2020 elections. In the early part of this year, health care stocks came under attack as both sides of the aisle jointly took aim at the industry. These attacks will continue and likely intensify as we draw deeper into the campaign season. We've already taken steps to insulate our portfolios by reducing our exposure to the healthcare sector.

Going Forward

We will continue to adjust portfolios as needed to best position for the environment we see ahead. All the while, you can be confident the companies in our portfolios are providing the Security, Income, and Growth that you depend on.

Blessings,

Your Investment Policy Committee